PICTET 1805

Flash Note

Scandinavian currencies

Good things come to those who wait

Pictet Wealth Management - Asset Allocation & Macro Research | 28 November 2017

From the start of September to 24 November, the Swedish krona and the Norwegian krone lost, respectively, 4.3% and 4.7% against the euro.

While the re-appointment of Stefan Ingves as Riksbank governor and the weak October inflation data have weighed on the krona, the weakness of the krone is a bit more puzzling given the rise in oil prices.

With inflation close to its target and deeply negative short-term interest rates, the krona should benefit from the most significant normalisation of policy of any major central bank. Our 12-month projection is for a rate of SEK9.30 against the euro.

The krone offers an attractive valuation and a positive carry, and it is backed by a positive current account. The global backdrop should reduce concerns about low inflation and lift the krone. Our 12-month projection is for a rate of NOK9.20 to the euro.

Recent months have not been kind to Scandinavian currencies: the Swedish krona and the Norwegian krone lost, respectively, 4.3% and 4.7% against the euro from the start of September to 24 November.

The weakness of the Swedish krona could be explained by some disappointment at the re-election of the very dovish Stefan Ingves as Riksbank governor, by some moderation in inflationary pressure in October, and by the currency's previous strong performance (the krona was the only major currency to record a gain against the euro earlier this year, rising 1.3% against the single currency in the eight months to end August).

For the krone, the reasons are more difficult to find. Notably, oil has performed well (the Brent oil price rose 22% between the beginning of September and 24 November), which should have been supportive. But it seems that ongoing low inflation (CPI inflation hit a 56-month low of 1.2% year-over-year in October) has become a major drag for the Norwegian currency.

Chart 1: Swedish inflation and unemployment

Source: Pictet WM – AA&MR, OECD, Thomson Reuters, November 2017

AUTHOR

Luc LUYET
lluyet@pictet.com
+41 58 323 1058

Pictet Group
Route des Acacias 60
CH - 1211 Geneva 73
www.pictet.com

Krona likely to strengthen further

The rationale for krona appreciation remains compelling: the growth outlook is robust, inflation is close to the Riksbank's 2% target, the output gap is closed and the currency is more than 20% undervalued against the euro on measures such as CPI-based purchasing power parity. Even the Riksbank acknowledges a path for appreciation of the trade-weighted krona in its economic projections.

However, the Riksbank is expected to remain cautious in its approach to monetary policy in order to avoid unwanted krona appreciation, which would jeopardise the considerable efforts it has made to bring inflation back close to its 2% target. This is all the more true with the recent re-appointment of Stefan Ingves as governor until the end of 2022. The Riksbank will likely take into consideration two key criteria before it decides to change its very dovish monetary stance. The first is the necessity for inflation to persist close to its target, with inflation expectations well anchored. The second criterion is likely to be the monetary policy of other major central banks, especially the European Central Bank (ECB). Indeed, the krona would likely experience significant upward pressure should the Riksbank's monetary policy become too hawkish relative to the ECB.

According to the Riksbank's inflation projections, inflation is expected to remain close to its 2% target over the next years. In addition, inflation expectations in the market have risen and are now close to 2%. Finally, the strong labour market and the positive output gap since 2016 can be expected to increase inflationary pressure. Overall, inflation that is close to target and the positive output gap mean that an extension of quantitative easing (QE) at the Riksbank's 20 December monetary policy meeting is not needed.

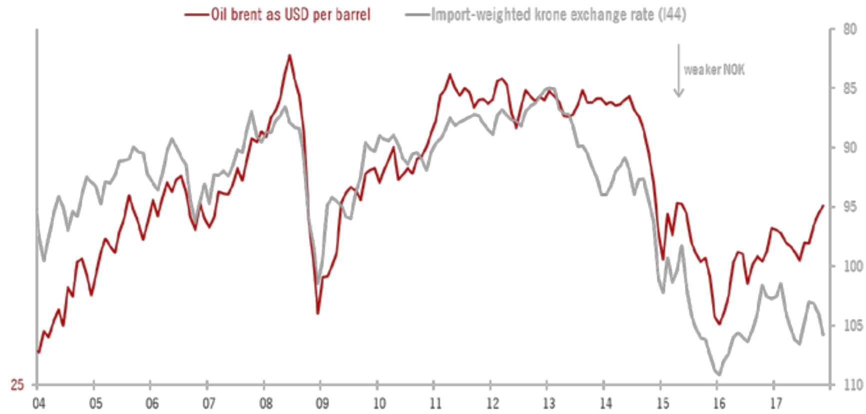
The open-ended extension of QE coupled with stronger forward guidance announced by the ECB on 26 October point to the Riksbank remaining patient (the latest Riksbank projection shows base rates rising slowly in the second half of 2018). However, our scenario includes the possibility that tightening in the euro area, when the ECB start raising rates, could come at a more rapid pace than is being currently expected by the market on the back of a gradual rise in core inflation and of a strong and resilient economic activity. This should be supportive of the single currency. A strong euro, which accounts for around 50% of the krona's trade-weighted index, should ease Riksbank concerns about a sharp appreciation of the Swedish currency.

Ultimately, given the extent of its accommodative monetary policy in recent years and given the current strong macro backdrop, the Riksbank's normalisation of policy should be the most significant of any major central bank, potentially leading to strong outperformance by the krona. That being said, housing market vulnerabilities and the dovishness of the Riksbank suggest that krona appreciation is unlikely to follow a straight line. Our 12-month projection is for a rate of SEK9.30 against the euro.

Looking for a catalyst for the krone

In our view, the Norwegian krone remains one of the most attractive currencies given its fundamental undervaluation (-18% relative to the US dollar), the improving growth outlook in Norway, and its positive carry. Furthermore, Norway's current account surplus makes the krone less risky than other commodity currencies. However, the currency's lacklustre performance despite the rise in oil prices since mid-2017 tends to suggest that the oil price is becoming less significant for the krone in an environment of low domestic inflationary pressure (*see chart 2*). Indeed, the recent divergence between the oil price and the trade-weighted krone may be explained by an inflation rate that has remained below 2% since June 2017 (the Norges Bank's inflation target is annual consumer price inflation of close to 2.5%).

Chart 2: Norwegian krone trade-weighted index vs. oil price



Source: Pictet WM – AA&MR, Norges Bank, Thomson Reuters, November 2017

Unfortunately, inflationary pressure should remain subdued, a by-product of the large negative output gap (estimated at -1.9% in 2017 by the OECD). The Norges Bank own projections see inflation remaining low in the years ahead, pointing to no rate hike in 2018.

Our modestly constructive view on the krone mostly stems from the likelihood that inflation will not move much lower given the positive global economic backdrop, while the Norwegian economy should benefit from a broad and resilient recovery of the euro area through the trade channel. Furthermore, a lot of negative news has already been priced into the krone, as can be seen by the extreme historic deviation of the EUR/NOK rate compared to its long-term trend (*see chart 3*).

Overall, the risk of further significant krone depreciation seems limited, while some spillover from the euro area recovery and recent rises in oil prices should outweigh risks stemming from housing market vulnerabilities. Our 12-month projection is for a rate of NOK9.20 to the euro.

Chart 3: EUR in NOK terms with long-term linear regression

Source: Pictet WM – AA&MR, Thomson Reuters, November 2017